

LATVIJAS BANKA

BANK OF LATVIA

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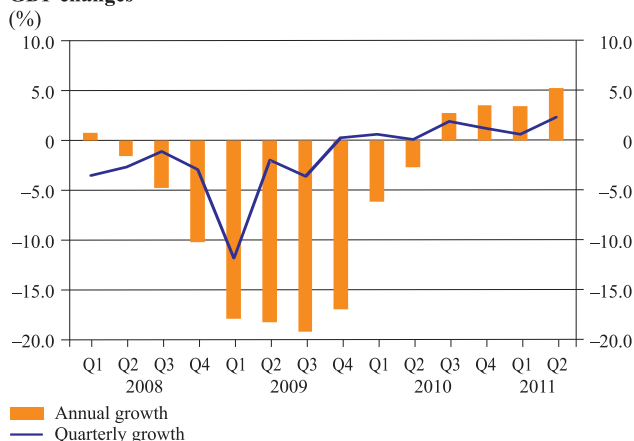
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1. Highlights

GDP growth accelerates amid global uncertainties

GDP changes



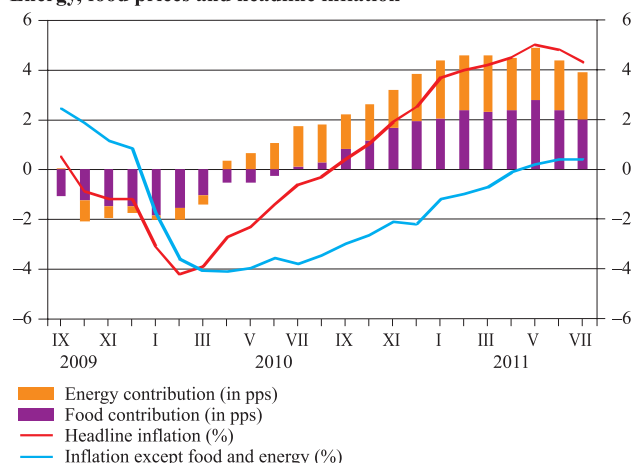
Flash estimates of Latvian GDP figures revealed better-than-expected results, with annual growth hitting 5.3%. Encouragingly, the pick-up in growth has led to a decline in unemployment figures, as employment has been following an upward trend for several quarters now.

Looking by sector, industry posted very good results along with transport and trade. Construction also improved relative to the first quarter. The financial results probably improved in the banking sector as well.

That being said, one has to acknowledge that the current realities of the global economic development appear rather grim. It is therefore unlikely that the Latvian economy will be able to resist the global trends for long and it can be expected that exports and hence GDP growth will slow down in the second half of the year.

Inflation falls, further decline expected

Energy, food prices and headline inflation



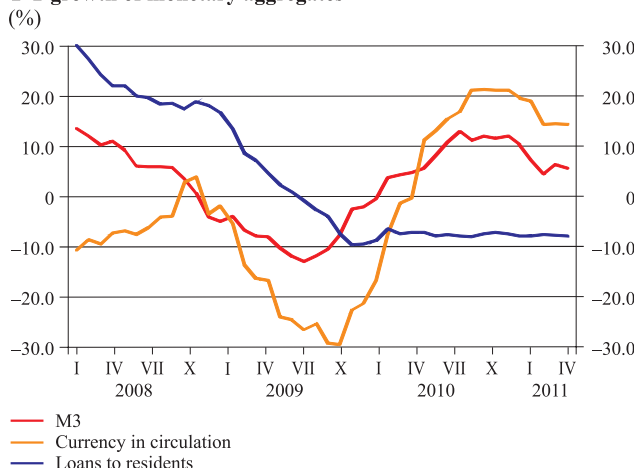
Annual inflation continued to drop for a second consecutive month, reaching 4.3% in July. The overall price decline was supported both by the stabilisation of global prices as well as seasonal factors.

Oil prices were rather stable on the world's commodity exchanges last month, and the fuel prices remained unchanged in Latvia. A drop, however, was observed in food prices.

The prices are expected to preserve relative stability in the coming months, with a substantial drop in the annual inflation expected next year. A more pronounced decline in inflation this year will be prevented by the rise in the excise tax on natural gas exerting an additional upward pressure on the output prices of other industries, e.g., on the heating tariffs.

Money supply levelled out

Y-Y growth of monetary aggregates



Although the demand for cash currency went up as the holiday season began, deposits with banks contracted, resulting in a decline in the money supply of the economy. The loan portfolio of banks continued to shrink, with the annual rate of decrease in domestic loans reaching 9.2% in June.

Against the background of deteriorating industrial confidence and the cautious attitude of consumers caused by the rising prices in the first half of the year, the current economic developments do not lead to a stable recovery in the growth of money supply; nor can we expect it in the near future. Likewise, no increase in lending is anticipated at least for this year because of the uncertainty currently surrounding the plans for cutting the 2012 budget deficit and the potentially unstable conditions in the external markets.

2. Macroeconomic Data

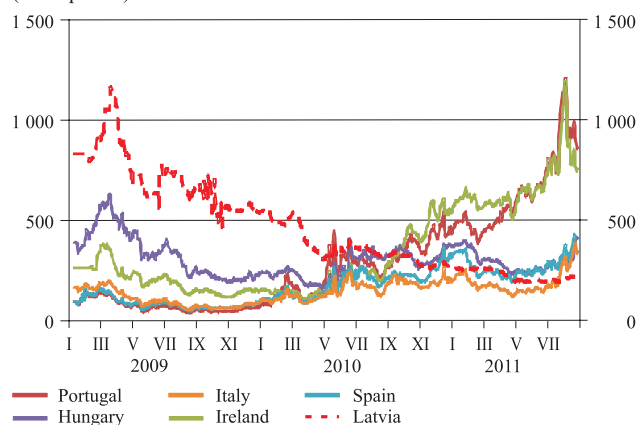
	Reporting period	Data (%)
Gross Domestic Product (GDP) (quarter-on-quarter growth; seasonally adjusted) 09.08.2011 The Second Quarter GDP growth rapid, but is it here to stay? 	2011 Q2 (flash estimate)	2.2
State budget Tax revenue (current month; year-on-year growth) General government expenditure (since the beginning of the year; year-on-year growth)	2011 VII 2011 VII	21.4 3.0
Consumer price changes Consumer Price Index (CPI; month-on-month growth) 12-month average annual inflation (to comply with the Maastricht Criteria) 08.08.2011 Annual inflation continued to fall in July; a more notable dip expected next year 	2011 VII 2011 VII	-0.3 2.9
Foreign trade Exports (year-on-year growth) Imports (year-on-year growth) 09.08.2011 Foreign trade activity down in June 	2011 VI 2011 VI	30.2 27.4
Balance of payments Current account balance (ratio to GDP) Foreign direct investment in Latvia (net flows; % of GDP) 11.08.2011 Current account in June supported by positive trends in services sales 	2011 Q1 2011 Q1	1.7 1.4
Industrial output Working day-adjusted industrial output index (year-on-year growth) 03.08.2011 Manufacturing in Latvia continues growing under conditions of global instability 	2011 VI	17.5
Retail trade turnover Retail trade turnover at constant prices (year-on-year growth) 29.07.2011 Retail posts a rapid rise in June 	2011 VI	4.7
Employment and unemployment Registered unemployment (share of working age population) 11.08.2011 Riga provides greater job opportunities; in the regions entrepreneurs more often select applicants among unemployed registered in State Employment Agency 	2011 VII	12.1
Monetary indicators Broad money M3 (year-on-year) 18.08.2011 Lending to businesses resuming; a stable rise in money supply not yet expected 	2011 VII	4.3

Sources: Treasury, Central Statistical Bureau of Latvia, and Bank of Latvia data.

3. In Focus

The recent political development has no effect on the economy of Latvia

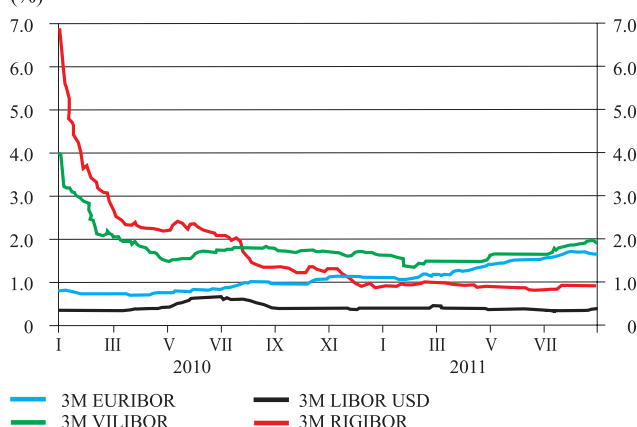
5-year credit default swaps
(basis points)



Government euro bond yields
(%)



Money market indices
(%)



The 2011 budget suggests that these September elections are unlikely to cause any delays in the adoption of the 2012 budget neither. Moreover, this time the required consolidation amount is considerably smaller than in the previous years. The worst consolidation decisions are already behind and a set of possible consolidation measures for the forthcoming year has already been detailed out at a technical level. Usually, extraordinary elections are perceived as an unnecessary and additional challenge to potential investors and market participants. However, in the Latvian case, they might result in more transparency and better business environment over medium-term, if the incoming government will complete the reforms required by the majority of citizenry.

This year has marked unprecedented developments in Latvian politics. On 28 May, Valdis Zatlers, the President of Latvia, proposed a referendum to dissolve the Saeima (Parliament of Latvia), a move taken never before in Latvia's history. The referendum was held on 23 July and the results were more than convincing: 94.3% of the population voted in favour of the dismissal of the Parliament. New elections will take place on 17 September and the re-elected Parliament will first convene presumably in October.

While Latvia has managed to stop recession and bring its economy back on a sustainable growth track, in this respect being internationally acknowledged as a success story, progress on some other issues was less remarkable. Namely, much stronger progress on moral issues has been requested by the population, particularly in bringing down the influence of money on politics. Thus the recent political developments were triggered by the Parliament voting against allowing the Corruption Prevention and Combating Bureau to search the residence of one of the MPs in a criminal proceeding.

In the meantime, the developments in the political arena have not led to any negative consequences or spill-over effects on the real economy. The financial markets remain calm. Credit default swap spreads are relatively low even despite the escalating uncertainty in the global financial markets in response to the US and the Euro area debt issues. Latvia continues successfully refinancing and extending the maturity profile of its debt: on 28 July, 5-year government bonds were sold with the weighted average yield of 4.083%. Earlier this year, on 29 June 10-year government bonds were sold with the weighted average yield of 5.705%. These developments demonstrate an ongoing decline of yields. Money market rates are stable and recently stay at historically low levels. At the same time, the economy continues its recovery, with the GDP growth reaching 5.3% in the 2nd quarter of 2011, underpinned by strong export performance and robust job creation that brings down unemployment and supports domestic demand.

The experience with the previous elections last October and the subsequent smooth adoption of the